

**DECLARATION OF STANLEY M. BESEN,
PADMANABHAN SRINAGESH, AND JOHN R. WOODBURY**

**AN ECONOMIC ANALYSIS OF THE
PROPOSED SBC/AMERITECH MERGER**

**Charles River Associates Incorporated
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1. Introduction

In reviewing the Bell Atlantic/NYNEX merger, the Federal Communications Commission concluded that reducing the number of independently controlled large Incumbent Local Exchange Carriers (ILECs) will require "future applicants [to] bear an additional burden in establishing that a proposed merger will, on balance, be procompetitive and therefore serve the public interest, convenience, and necessity."¹ As demonstrated in this and the accompanying declarations, SBC and Ameritech have not established that their proposed merger will be procompetitive and serve the public interest, convenience, and necessity.

This Declaration and the accompanying declarations by Professors Michael L. Katz and Steven C. Salop,² Dr. John B. Hayes,³ and Professor Joseph Farrell and Dr. Bridger M. Mitchell⁴ analyze the competitive effects of the proposed merger of SBC and Ameritech. These analyses show that the anticompetitive effects of the proposed SBC/Ameritech merger are likely to be significant. They also show that some of the most important efficiencies that are claimed by the merging parties are either unlikely to be obtained or are not merger-related. On the basis of these

¹ *In the Applications of NYNEX Corporation and Bell Atlantic Corporation for Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries*, Memorandum Opinion and Order, FCC 97-286, File No. NSD-L-96-10, released August 14, 1997 (henceforth Merger Order), Para. 16.

² Declaration of Michael L. Katz and Steven C. Salop, "Using A Big Footprint to Step on Competition: Exclusionary Behavior and the SBC-Ameritech Merger," October 14, 1998 (henceforth Katz and Salop Declaration).

³ Declaration of John B. Hayes, "Market Power and the SBC-Ameritech Merger," October 14, 1998 (henceforth Hayes Declaration).

⁴ Declaration of Joseph Farrell and Bridger M. Mitchell, "Benchmarking and the Effects of ILEC Mergers," October 14, 1998 (henceforth Farrell and Mitchell Declaration).

analyses, we conclude that the proposed merger is likely to harm competition and consumers, and thus is contrary to the public interest.

According to SBC and Ameritech, a major objective and procompetitive benefit of the proposed merger is the implementation of a “National-Local Strategy” (NLS). Initially, this Strategy consists of the merged SBC/Ameritech entering 30 major markets outside their combined home regions with the goal of serving a substantial portion of the total telecommunications needs (local, long-distance, high-speed data, and other) of the major national and global corporations that are headquartered in their home regions. SBC claims that it will later extend service to small businesses and residential users.

SBC and Ameritech argue that the NLS will bring greater competition to the markets they enter by offering more choices to the customers they elect to serve. They also argue that the NLS will bring additional competition to their own service territories as other LECs respond by entering the SBC/Ameritech service territories.

Perhaps most significantly, SBC claims that the NLS cannot be implemented without the proposed merger. This is central to SBC’s claim that the merger serves the public interest. SBC also asserts that the merger will lead to other cost savings, even if the NLS is never implemented, and claims that the merger will not produce any adverse competitive effects.

This Declaration and the accompanying declarations of Professors Katz and Salop, Dr. Hayes, and Professor Farrell and Dr. Mitchell contain detailed analyses of

the impact of the proposed merger on competition. The principal conclusions of these analyses are the following:

- SBC has not established that the merger is necessary for consumers to obtain all or even most of the alleged benefits of the NLS. Moreover, other important efficiency benefits claimed by SBC are either unlikely to be achieved or are not merger-related.
- SBC fails to credibly establish its contention that the merger will result in lower prices for residential telephone service in the SBC and Ameritech service areas and in the 30 markets it claims it will enter under the NLS.
- An interLATA strategy like the NLS implemented by the combined SBC/Ameritech would be accompanied by *even greater* anticompetitive harm than would similar strategies implemented independently by SBC and Ameritech. These harms will be felt in those (downstream) markets, such as the market for local calls or the market for interLATA calls, where rivals must rely on essential facilities provided by SBC and Ameritech and on their ability to interconnect with SBC and Ameritech customers. The proposed merger would increase both the incentives and the ability of the combined entity to exploit its control over essential facilities to disadvantage its rivals. Moreover, even if SBC/Ameritech were to satisfy Section 271 conditions, it would still retain the ability to disadvantage rivals. Finally, imposing conditions on the merged entity to deal with these competitive concerns would be ineffective, as demonstrated by Bell

Atlantic's failure to meet the conditions imposed by the Commission in approving the Bell Atlantic/NYNEX merger.

- The merger would eliminate SBC and Ameritech as potential LEC entrants into each other's service territories.
- The merger would impair the ability of regulators to use industry benchmarks to determine whether an incumbent firm is discriminating against rivals while, at the same time, increasing the need for such regulatory supervision.
- SBC and Ameritech possess market power in the sale of local exchange and exchange access services and are likely to retain that power for some time to come.

The analyses supporting these conclusions, some of which summarize the analyses contained in the accompanying declarations, are presented below.

Section 2 of this Declaration analyzes SBC's claim that the merger is a prerequisite for the implementation of the NLS and concludes that this claim is unwarranted.

Indeed, we show that the link between the NLS and the proposed merger is tenuous at best.

Section 3 considers SBC's claims that the NLS will result in lower prices in the out-of-region cities targeted by the Strategy, as well as within the combined SBC/Ameritech service territory. We explain why out-of-region prices are unlikely to be affected in any significant way and why the merger is likely to *increase* prices within the SBC/Ameritech region. Moreover, there is no reason to believe that the

NLS, even if implemented, would promote increased competition for local residential or small business telephone users.

Section 4 assesses the claim that the NLS will reduce the risk of stranded assets, costs that SBC asserts would otherwise be borne by local exchange ratepayers. In fact, SBC has not demonstrated that this risk will be reduced.

Section 5 examines the efficiencies — in addition to those claimed for the NLS — that SBC claims would result from the merger and concludes that many or most of these benefits are not likely to be realized. It also explains why SBC has not made a convincing case that the remaining benefits, to the extent that they are realized, are merger-related.

Section 6 draws on the analyses of vertical foreclosure by Professors Katz and Salop to evaluate the likely impact of the SBC/Ameritech merger on competition in the supply of local and interexchange services. These analyses conclude that the proposed merger will increase the incentives and ability of SBC and Ameritech to harm competition in the supply of these services and the consumers of these services. Section 7 explains why the merger would eliminate SBC and Ameritech as potential local exchange entrants into each other's service territories.

Section 8 summarizes the conclusions of Professor Farrell and Dr. Mitchell regarding the impact of the merger on the ability of regulators to rely on industry benchmarks to evaluate the behavior of Incumbent Local Exchange Carriers (ILECs). It explains why the merger would make it more difficult for both federal and state regulators to employ either average industry performance or best practices as

yardsticks against which to compare the behavior of ILECs. The merger would also reduce the ability of regulators to engage in heightened scrutiny of “worst practices.”

Section 9 summarizes Dr. Hayes’ analysis of the markets for local exchange and exchange access services and concludes that SBC and Ameritech are dominant providers in their geographic markets. Moreover, given the limited scope of actual entry and the announced plans of potential entrants, it is evident that SBC and Ameritech will remain dominant for some time to come, and will retain control of the essential facilities from which they derive their ability to harm competition.

Section 10 summarizes the results of all of these analyses and concludes that the merger would not be in the public interest and therefore should not be approved.

2. The Merger Is Not a Prerequisite for the National-Local Strategy

An important public interest benefit that SBC has claimed for the proposed SBC/Ameritech merger is that it would permit SBC to pursue a National-Local Strategy. Under this Strategy, SBC would initially offer bundled telecommunications services (local exchange, long-distance, high-speed data, and others) in 30 markets outside the SBC and Ameritech service territories to those large and medium-size business customers with headquarters within the SBC and Ameritech service territories.⁵

⁵ Affidavit of James S. Kahan, July 20, 1998, Para. 27 (henceforth Kahan Affidavit). Kahan states that “We have identified 224 Fortune 500 companies that are headquartered in the 13 states served by SBC, Ameritech and SNET” (Para. 49). Similarly, in the Report of Dennis W. Carlton, July 20, 1998

The NLS is based on the premise that large business firms increasingly prefer a single point of contact for the purchase of all of their telecommunications (local and long-distance voice, data, and other) services.⁶ In order to be the single point of contact, SBC claims that it must have “coverage” of at least 70-80% of a firm’s telecommunications expenditures, since it claims that its rivals will offer such coverage.⁷ SBC claims that the merged firm must offer both out-of-region and in-region interLATA communications to almost any large national or global firm with headquarters in SBC’s or Ameritech’s home regions, which are the initial targets of the NLS, in order to implement the Strategy.⁸

SBC claims that the merger is essential to the pursuit of the NLS because, on its own, it would not have been prepared to enter markets outside of its region to offer this service.⁹ However, there are a number of reasons to be skeptical about this claim. Internal inconsistencies and vital gaps in supporting evidence undermine

(henceforth Carlton Report), Carlton states: “These data indicate that SBC’s eight home-state region is headquarters to 129 Fortune 500 companies” (Para. 15); and further: “Similarly, Ameritech’s five home states (Illinois, Michigan, Ohio, Wisconsin and Indiana) are headquarters to 91 Fortune 500 companies” (Para. 18). Some of the Fortune 500 companies with headquarters in these states may not be in SBC’s or Ameritech’s service territories. The NLS would apparently be less profitable if these companies were excluded.

⁶ Kahan Affidavit, Para. 30.

⁷ Kahan Affidavit, Para. 48.

⁸ SBC declares that “These customers seek the same services, features, functions and capabilities for all of their locations...” (Kahan Affidavit, Para. 30). SBC could not meet these customers’ needs if it did not provide in-region long-distance calling in all of its home states. SBC’s assumptions regarding the disposition of its Section 271 filings are not described in its submission.

⁹ Kahan Affidavit, Para. 80.

SBC's arguments that the merger is a prerequisite for the successful implementation of the NLS.

First, SBC has not made a commitment to implement the NLS if the merger is approved. Although SBC claims to have made a firm commitment to implement the NLS, it nonetheless appears to leave the door open to implementing a less ambitious version of the Strategy.¹⁰ The less ambitious version, which may require entry into fewer cities, may well be within the individual capabilities of SBC and Ameritech absent the merger. Because SBC does not provide the underlying data that would permit an independent evaluation of the Strategy's profitability, or even the means for identifying the "must-follow" customers, we (and the Commission) are unable to determine how much less profitable entry would be if (for example) both SBC and Ameritech entered fewer cities, or if SBC and Ameritech were to satisfy a somewhat smaller percentage of a firm's telecommunications needs.

Second, SBC and Ameritech claim that they would lose large numbers of important customers to rivals that offer nationwide service unless they "follow the customer" by offering them service for a substantial proportion of their telecommunications needs. However, if their view of the requirements of their

¹⁰ On the one hand, SBC states: "SBC has made a significant and serious commitment to the national/local strategy, repeatedly stressing that both the merger with Ameritech and 30-city entry plans are essential elements of its future success. This commitment has been made in representations to investors, analysts, the Congress, the Securities and Exchange Commission, the Department of Justice, the Federal Communications Commission and state regulators" (Carlton Report, Para. 7). On the other hand, SBC states: "We are continuing to refine our analysis of these markets by studying the locations where our current customers have facilities. As a result of this review, we may modify this list to ensure we are in the markets in which our customers have significant operations" (Kahan Affidavit, Para. 35).

customers is correct, SBC and Ameritech will be forced to follow their customers even if they are not allowed to merge. Because these customers represent a very large share of their businesses¹¹ and because they “will be even more important in the future,”¹² SBC and Ameritech may have little choice but to attempt to compete for this business out of their home regions even if the merger does not occur. As SBC itself observes: “We cannot remain idle while our competitors capture the huge traffic volumes generated by a relatively small number of larger customers.”¹³ SBC’s view of the critical importance of large business customers appears to be inconsistent with its willingness to lose them if the merger is not approved.

Third, an essential aspect of the merging parties’ argument is that they can compete successfully only for those large business customers who have headquarters in their home regions.¹⁴ According to SBC, the merger is important because it provides “the critical mass of major customers that [SBC] can follow to establish a beachhead in out-of-region markets.”¹⁵ Thus, according to this theory, SBC would not be an effective competitor for a nationwide firm with headquarters in,

¹¹ SBC observes that the 809 businesses that represent the top 1% of its business customers generate 37% of its large and medium business revenues and 8% of total company revenues (Kahan Affidavit, Para. 13).

¹² Kahan Affidavit, Para. 13.

¹³ Kahan Affidavit, Para. 13.

¹⁴ “... the National-Local Strategy contemplates initially marketing to and securing the business of large corporations with multi-state requirements whose headquarters are located in the new SBC territory” (Kahan Affidavit, Para. 40).

¹⁵ Kahan Affidavit, Para. 11. SBC claims that “... the combination of SBC and Ameritech creates a company with a broader geographic customer base to be ‘followed’...” (Kahan Affidavit, Para. 76).

say, Chicago, even if a very large proportion of the telecommunications needs of that firm were outside Ameritech's service territory, perhaps even if those requirements were largely in SBC's own territory. In the view of the merging parties, they can compete effectively to serve the telecommunications needs of large firms only if they are located in the same region as the home offices of the purchasing firms.

Although it is, of course, true that the merger increases the number of Fortune 500 companies with headquarters in the merged company's region, it is not clear why "...SBC's and Ameritech's existing relationships increase the likelihood that the merged firm could successfully compete to become a nationwide supplier of services for such customers."¹⁶ Indeed, SBC has failed to establish any link in the future competitive environment it describes between being located in the same region as the headquarters of a customer and obtaining that customer's telecommunications business.

The October 12, 1998, Affidavit of Mr. Steven Signoff, Vice President of Strategic Business Development at Sprint (henceforth Signoff Affidavit), shows that SBC's assumptions about the purchasing behavior of large businesses are inconsistent with the way these businesses currently behave. SBC claims that it must be the sole or primary source contractor to large businesses if it is to compete. Large businesses, however, frequently and deliberately divide their purchases

¹⁶ Carlton Report, Para. 25.

among multiple providers instead of seeking a single source of supply, as SBC claims. Mr. Signoff further observes that if SBC and Ameritech continue to offer data and voice services separately (as appears to be the case), "there would appear [to be] no overriding reason for buyers to utilize a single vendor".¹⁷

It should also be noted that none of SBC's competitors are capable of offering sole source arrangements, so there is no competitive necessity for SBC to do so.¹⁸ No single company now has, or is likely to have in the foreseeable future, this end-to-end capability. The use of leased facilities by SBC is no more of a disqualifier than would be an Interexchange Carrier's (IXCs) purchase of access services to supplement its own services. Moreover, although some large businesses order their telecommunications services centrally, as SBC assumes, many others do not. Because the initial targets of the NLS, "the thousand largest companies in the United States, many of which have global needs and requirements,"¹⁹ are highly sophisticated, it is unreasonable to assume that large telecommunications suppliers with account teams that are physically located in the same place as the buyer, but with traditional service territories that do not include the buyer's headquarters, face an important competitive handicap.²⁰

¹⁷ Signoff Affidavit, Para. 9.

¹⁸ Id.

¹⁹ Kahan Affidavit, Para. 30.

²⁰ SBC notes that it is handicapped in competing with AT&T, WorldCom, and Sprint because it lacks their brand-name recognition (Kahan Affidavit, Para. 76). Whatever role brand-name recognition may have in the competition for residential and small business customers, it is unlikely to be an important factor for the large sophisticated business customers who are the initial targets of the National-Local Strategy. Curiously, SBC notes that "SBC and Ameritech have significant experience competing out-

Fourth, the merging parties do not explain why they cannot separately be facilities-based competitors in all of the 30 out-of-region markets even if they can follow only the large and medium-size business customers headquartered in each of their service territories. SBC does not establish that the costs of switches, unbundled loops, and marketing/customer service would be significantly higher for each party implementing the NLS separately than they would be for the combined companies.

If a single switch could serve all the target customers in each of the 30 cities, the merger could result in significant savings in switching costs by permitting SBC and Ameritech to share a single switch. However, the merging parties are planning to employ several switches in each of these markets.²¹ Each firm could deploy fewer switches if they entered the markets separately and obtained fewer customers. Thus, any savings in switch costs that the merged firm would experience relative to those for SBC or Ameritech entering separately are likely to be small.

The NLS envisions using unbundled loops to reach many large business customers. SBC does not establish that there are significant economies of scale in ordering unbundled loops. Similarly, dedicated account representatives are typically used to serve large business customers, and the number of such representatives

of-region. SBC has been an effective competitor out-of-region in the wireless market since 1987” (Kahan Affidavit, Para. 69).

²¹SBC claims that it will place “in excess of 60 switches in the 30 markets” (Kahan Affidavit, Para. 37) and that it will install an additional 80 switches to serve residential and small business customers (Kahan Affidavit, Para. 37). “Our current strategy contemplates that we will have at least two switches located in each of these 30 markets within three years of the closing of the SBC/Ameritech merger” (Kahan Affidavit, Para. 55).

can be expected to vary with the number of accounts served. SBC has not established that there are significant scale economies in the marketing and sales function.

While SBC and Ameritech acting separately may face somewhat higher costs than the merged SBC/Ameritech, it is by no means obvious that these cost increases are sufficient to render the NLS infeasible for SBC or Ameritech separately. SBC and Ameritech imply, but do not establish, that they cannot enter markets outside their regions at a smaller scale.

Fifth, if SBC and Ameritech accept that they must offer service in the other markets in order to follow their home market customers,²² they could do so without the merger by relying on facilities leased from the incumbent LECs or other suppliers of capacity. Indeed, SBC is apparently already considering a “smart build” strategy for the merged firm in which it “will construct its fiber networks where the customers most need them and will otherwise utilize available inter-city and other transport capabilities that are already constructed...These fiber networks and switches will be supplemented by extensive utilization of unbundled network elements, primarily local loops.”²³ As a result, the effect of blocking the merger could simply be to make Ameritech and SBC somewhat more reliant on leased

²² SBC has as “[o]ne of [its] most fundamental *assumptions*... that, in order to compete effectively for the business of our largest customers, we must have ‘coverage’ of approximately seventy to eighty percent (70%-80%) of the telecommunications expenditures made by those customers” (Kahan Affidavit, Para. 48, emphasis added).

²³ Kahan Affidavit, Para. 39.

facilities than if the merger were permitted. Since leased facilities do not require large capital outlays or prolonged construction, entry strategies that rely more heavily on leasing facilities may be within the individual capabilities of Ameritech and SBC. If so, the merger would not be a prerequisite for each firm to mount an independent NLS. Furthermore, the extent to which the merged firm would enter with its own facilities in more areas than would SBC and Ameritech absent the merger is uncertain since the merged firm apparently also would rely on leased facilities to some unspecified extent.

The examples presented by Carlton²⁴ of instances in which SBC was unable to respond to RFPs due to its limited geographic coverage may explain why SBC must provide service in many markets in order to compete effectively, *not* why the merger is necessary for it to do so. Carlton's claim that the data "confirm SBC's and Ameritech's view that each is poorly situated to use its *own* facilities to respond successfully to RFPs issued by multi-location customers for a nationwide telecommunications provider" is *definitionally* true but begs the question of why using one's own facilities is necessary to compete successfully.²⁵ Moreover, SBC and Ameritech can hardly claim that leasing facilities imposes a great competitive

²⁴ Carlton Report, Para. 19.

²⁵ Carlton Report, Para. 19, emphasis added. Because Carlton did not compare the characteristics of the RFP applicants and winners with SBC and Ameritech, one cannot infer that failure of SBC and Ameritech to respond to the RFPs was due to insufficient market presence.

handicap since they claim that suppliers relying on leased facilities are very effective competitors.²⁶

Sixth, Carlton notes that “At the most basic level, the proposed transaction speeds deployment of the out-of-region plan by reducing the number of out-of-region cities in which SBC must build facilities in order to gain a nationwide footprint.”²⁷ However, the merger reduces that number only slightly for SBC – from 37 to 30 – and, in any event, it is unclear why the merger accelerates achieving national coverage since SBC can build facilities *simultaneously* in the seven additional cities it needs to reach out-of-region locations of the customers it follows.

Finally, there is substantial evidence from the success of Competitive Access Providers (CAPs) and Competitive Local Exchange Carriers (CLECs) like Teleport and MFS that firms can and do compete effectively, and grow to quite considerable size, by serving the communications needs of large business customers *without having a single customer to “follow.”* After all, these CAPs and CLECs had no local exchange or exchange access customers, nor did they have any interexchange customers, when they began to operate. What they did have were services that could attract large business customers away from the ILECs. It seems unlikely that

²⁶ “These regional and niche competitors can provide a package of goods and services without the significant capital and other requirements of the ILECs. As such, the niche providers are positioned to be very effective and profitable competitors” (Kahan Affidavit, Para. 26).

²⁷ Carlton Report, Para. 24.

SBC would be any more disadvantaged in competing for the business of, say, Sears in Chicago than was either MFS or Teleport when they began their operations.²⁸

For all the reasons discussed, we conclude that the merger is not a prerequisite for the successful implementation of the NLS.

3. The National-Local Strategy Will Not Result in Lower Local Exchange Prices

SBC and its economists assert that the implementation of the National-Local Strategy will result in lower prices for consumers. This is claimed to happen for three reasons. First, SBC asserts that the merger will permit SBC/Ameritech to be a more effective rival in bidding for the telecommunications business of very large concerns.²⁹ Second, SBC claims that when SBC/Ameritech begins to provide a rival residential local exchange service in those out-of-region markets that are part of the NLS, the ILECs in those markets will reduce local exchange prices in response to the entry of SBC/Ameritech.³⁰ Third, SBC contends that prices within SBC/Ameritech service territories will fall when the ILECs whose territories have been invaded respond by entering the SBC/Ameritech territories.³¹

²⁸ See the Report of Richard Schmalensee and William Taylor, National Economic Research Associates, July 21, 1998 (henceforth Schmalensee and Taylor Report). The authors assert that there are substantial economies of scale in the provision of local service (Para. 8). This assertion implies that SBC and Ameritech would have a cost advantage over the smaller CAPs with whom they compete.

²⁹ Carlton Report, Para. 4.

³⁰ Report of Richard J. Gilbert and Robert G. Harris, July 21, 1998 (henceforth Gilbert and Harris Report), Para. 28.

³¹ Gilbert and Harris Report, Para. 28.

With respect to the first claim, we explained above why SBC has failed to demonstrate that the merger is necessary to implement the NLS. However, even if one assumed that the merger was necessary, the consumer benefits of the merger for large business customers are likely to be quite small. As most observers appear to concede, the rivalry for the patronage of large business customers is more significant than the rivalry for other consumer groups.³² More vigorous participation by SBC/Ameritech is, therefore, unlikely to yield large competitive benefits. Indeed, SBC itself notes the intensity of competition to serve large business customers.³³

With respect to the second assertion, there is little doubt that if the merger were to result in the much-anticipated competition for the patronage of residential customers, the benefits could be considerable. However, SBC does not offer any evidence to support its claim that it will be able to serve most residential customers profitably once it has acquired the patronage of large businesses. Indeed, the experience to date contradicts SBC's claim. Firms with a mixture of owned and leased facilities like TCG and MFS have for years been competing with the ILECs to serve the telecommunications demands of large businesses. Despite that history, however, none of these rivals has become a significant competitive alternative for residential consumers. As Dr. Hayes indicates in his Declaration, entry into local

³² See Hayes Declaration for a discussion of the options available to high-volume business customers located in major urban centers. In his Report, Carlton (Para. 12) notes that "RBOCs (and other incumbent LECs) are increasingly subject to competitive pressures, particularly for services to business customers."

³³ SBC claims that "... our competitors capture the huge traffic volumes generated by a relatively small number of larger customers" (Kahan Affidavit, Para. 13).

exchange and exchange access services for this market segment has not been significant to date. SBC provides no reason why its NLS makes it more likely that it will compete for residential consumers in out-of-region areas when other suppliers of services to large business customers have not done so, despite the fact that they, too, have large businesses as “anchor tenants.” Indeed, SBC notes that it is unprofitable to serve these residential customers, and that its rivals are cherry picking in its region.³⁴

Finally, SBC asserts that out-of-region ILECs will enter the territories of SBC/Ameritech in response to the entry of SBC/Ameritech in the NLS's 30 cities. However, SBC's analysis neglects the control that SBC and Ameritech will retain over essential facilities in their own regions and, thus, their ability to foreclose competitors that seek to enter their territories. When SBC's control over its essential facilities is accounted for by the analysis of the merger, the conclusion that the merger will enhance in-region competition does not appear to be warranted.

Initially, virtually all entrants into SBC's post-merger territory will require access to SBC's facilities or services (Unbundled Network Elements (UNEs) or wholesale offerings or interconnection) in order to compete.³⁵ As Professors Katz

³⁴ SBC observes that “... prices which the ILECs charge these customers have been maintained at artificially high levels in order to subsidize the rates charged residential customers through regulatory fiat” (Kahan Affidavit, Para. 21). However, it is likely that the revenues from both POTS and the array of vertical services purchased exceed the costs of serving many residential consumers.

³⁵ Gilbert and Harris contend that “many... new technologies...do not require access via the local loop provided by the incumbent LEC” (Gilbert and Harris Report, Para. 15). However, many of the most important new entrants will continue to require such access for a considerable period of time, and all will need interconnection.

and Salop show in their Declaration, the combined SBC/Ameritech will have both increased ability and incentives to vertically foreclose local exchange rivals after the merger. This foreclosure may take several forms, among them: (a) degradation in the quality of service SBC offers to entrants, including access to its Operations Support Systems (OSSs) for pre-ordering, ordering, and provisioning service; (b) delays in repair and maintenance of leased facilities or purchased services; (c) limited access and inflated prices for collocating facilities in SBC's central office; and (d) bundling of otherwise separable facilities.³⁶ If SBC successfully raises its rivals' costs in its enlarged service territories in this fashion, prices in these service territories will be higher than they otherwise would have been.

As discussed in greater detail by Professors Katz and Salop (and as summarized in Section 6 of this Declaration), the merger will increase SBC and Ameritech's incentives and ability to engage in strategies that raise the costs of their local exchange rivals. Consequently, the entrants may not be able to discipline the merged parties, and prices in SBC's territory may rise above what they would have been had the merger not occurred.

In sum, the SBC/Ameritech analysis is incomplete because it ignores the effects of the merger on the ability and incentives of the merged entity to exclude

³⁶ For a useful compendium of the types of problems faced by an entrant in offering new telecommunications services, see Northpoint Communications, "Proposed Remedies for Promoting DSL Competition" (undated). Northpoint observes (p. 1) that "while each ILEC currently provides some unbundled network elements under reasonable terms and conditions, each ILEC also erects a host of onerous and unnecessary barriers to increasing competitive opportunities. Moreover, there is no consistency, as every barrier that one ILEC claims is necessary, another ILEC avoids entirely."

rivals. Once those effects, which are analyzed in detail by Professors Katz and Salop, are taken into account, the conclusion that local exchange prices will fall in SBC's service territory does not follow. Indeed, once it is recognized that the merger creates incentives for the merging parties to increase the extent to which they exploit their control of transport and termination, one cannot conclude that the merger will result in consumer benefits through lower prices in the SBC service territory.

4. The Merger Would Not Likely Reduce the Risk of Stranded Assets

Gilbert and Harris contend that one by-product of the merger would be a reduction in the likelihood that SBC and Ameritech would have stranded assets whose costs would be borne by local exchange ratepayers.³⁷ In particular, they claim that, in the absence of the merger, SBC will find it more difficult to retain its large business customers, who currently generate disproportionate contributions to fixed costs, so that SBC will face an increased likelihood of stranded assets. Gilbert and Harris assert that "ratepayers will be left responsible for the stranded assets...."³⁸

Gilbert and Harris conclude that, in the absence of the merger, the risk of stranded assets will be higher than otherwise. However, their analysis is at best

This suggests that benchmarking may be needed to judge the reasonableness of the terms and conditions imposed by individual ILECs. See the discussion of benchmarking below.

³⁷ Gilbert and Harris Report, Para. 27.

³⁸ Gilbert and Harris Report, Para. 27.

incomplete since it does not consider ratepayer risk in the event the merger is approved and the NLS is implemented. A more complete analysis comparing ratepayer risk under the NLS to ratepayer risk without a merger indicates that this risk would be increased, not decreased, by the merger.

First, consider the likely impact of competition on ratepayers in the absence of the merger. Large companies are sophisticated purchasers that often use RFPs, second sourcing, long-term contracts with most favored nation clauses, and contract renegotiations to obtain favorable terms from their telecommunications suppliers. SBC concludes that competition for large business customers will be vigorous.³⁹ Therefore, the large business segment is unlikely to generate large profits or contributions in the future, whether or not the proposed merger is consummated. The loss of contributions from big businesses will have to be made up from other sources, such as cost-saving innovations, new product introductions, universal service funding, and reduced dividends to shareholders. If the combined effect of these measures does not result in full cost recovery, there is some risk that ratepayers may be required to pay more than they otherwise would for basic services. A strategy of following large business customers cannot, in and of itself, generate traditional margins and reduce ratepayer risk.

Moreover, SBC's own business analysis suggests that the NLS is extremely risky. Kahan states that: "Over the next ten years, the operating expenses involved

³⁹ Kahan Affidavit (Para. 64) and Carlton Report (Para. 12).

in these out-of-region operations will be in excess of \$23.5 billion. In addition, these capital requirements and operating expenses are heavily weighted towards the early years of the business plan – a return on this investment does not occur until the later years. Indeed, the magnitude of the investment required to sustain this venture is demonstrated by the fact that these operations are expected to generate negative cumulative cash flow until the ninth year of the NLS.”⁴⁰

SBC apparently intends to pass the risks of pursuing the NLS on to its in-region customers, and not to its shareholders. In his Affidavit, Kahan states: “Indeed, the business plan contemplates having a cumulative negative cash flow for nearly ten years. The *remaining business operations* of the new SBC must carry these negative cash flows while we continue to grow our existing business, grow our customer base, compete in the market where we are the incumbent, maintain and enhance our existing networks *and fund dividends*.”⁴¹

If this statement means what it says, the dividends received by SBC shareholders will be unchanged during a period when the NLS generates negative cash flow. During the same period, SBC’s remaining business operations, which include basic telephone services, will be used to fund the negative cash flow. A purpose of the merger thus appears to be the aggregation of a sufficiently large

⁴⁰ Kahan Affidavit, Para. 58.

⁴¹ Kahan Affidavit, Para. 80, emphasis added.

collection of ratepayers to fund several years of negative cash flows through higher prices for basic services, while continuing to pay shareholder dividends.⁴²

In the absence of other documented efficiencies, one may conclude that a major objective of the NLS is to shift risk from SBC's and Ameritech's shareholders to its ratepayers. While the reduction of risk to SBC's shareholders has been clearly identified, SBC does not identify how risks to society as a whole (including ratepayers) will be reduced. The transfer of risk without any reduction in aggregate risk is not a social benefit.

In sum, the NLS appears to hold greater risks for the ordinary small business and residential consumer than the possibility of stranded assets if the merger application is rejected.

5. Other Claimed Merger-Related Efficiencies Are Unlikely To Be Large

In their report in support of SBC's application, Gilbert and Harris claim that, in addition to the benefits that SBC claims will result from the NLS, the merger of SBC and Ameritech will benefit consumers in five respects:

- a) By combining the resources of SBC and Ameritech, the merger will enhance investment opportunities and *speed the introduction of new services and technologies.*

⁴² Schmalensee and Taylor concede as much: "A substantial base of current customers and revenues is necessary to maintain earnings growth and spread risk while following customers into out-of-region local markets" (Schmalensee and Taylor Report, Para. 16).

- b) The merger will *facilitate diffusion of best practices* between SBC and Ameritech, thereby lowering costs and facilitating the deployment of new services.
- c) The merger will make possible other cost reductions by exploiting *economies of scale and scope* and by enabling *purchasing economies*.⁴³
- d) The merger will facilitate the efficient and *timely development of necessary standards*.⁴⁴
- e) The merger is expected to generate \$778 million in *revenue synergies*.⁴⁵

Similar claims are made in the Report submitted by Professor Carlton and the Report submitted by Professor Schmalensee and Dr. Taylor. Each of these points is analyzed below.

5.1 The speed of introduction of new services and new technologies

Gilbert and Harris argue that the merged company would accelerate the delivery of new services because Research and Development (R&D), which is integral to new service and technology introduction, has the characteristic of a public good and can be broadly applied across the merged company without any dilution in

⁴³ Gilbert and Harris Report, Para. 27, (points a, b, c); emphasis added.

⁴⁴ Gilbert and Harris Report, Para. 34.

⁴⁵ Gilbert and Harris Report, Para. 39. emphasis added.

value.⁴⁶ In this way, a firm can appropriate more of the gains from innovation through larger output sales, and less of the total profits from innovation are captured by imitating competitors who “free ride” on the firm’s innovation efforts. As a result, Gilbert and Harris claim that the merged firm’s incentives to innovate would increase, a conclusion that they assert is “supported by economic theory and by the experience of the merger of SBC and Pacific Telesis.”⁴⁷

The public-good characteristics of R&D can play a particularly important role in affecting the amount of effort devoted to innovation in markets if the innovating firm has a large market share. That is, if the firm has a very small market share, then its ability to appropriate the full return to innovation may be very limited, no matter how large the firm is in absolute size. If Gilbert and Harris are suggesting that the merger will substantially increase the share of SBC/Ameritech in the relevant markets, then the Gilbert and Harris analysis of the effect of the merger on innovation incentives is incomplete. The standard Industrial Organization textbooks devote considerable space to the conceptual question of whether a market served by a monopolist has a greater incentive to innovate than one characterized by competition.⁴⁸ These textbooks note that, although a monopolist can appropriate

⁴⁶ Gilbert and Harris Report, Para. 30. Carlton makes a similar claim (Carlton Report, Para. 10) and Schmalensee and Taylor offer similar arguments (Schmalensee and Taylor Report, Paras. 18-21).

⁴⁷ Gilbert and Harris Report, Para. 30. Similarly, Schmalensee and Taylor state: “The merger will stimulate less costly and more rapid development of new telecommunications products and services because the return to the introduction of new products and services will be higher in the merged firm” (Schmalensee and Taylor Report, Para. 18).

⁴⁸ See, for example, F.M. Scherer and D. Ross, *Industrial Market Structure and Economic Performance*, Third Edition (Boston: Houghton Mifflin Company, 1990), pp. 630-644.

more of the return from innovation, its incentives to innovate may be diminished by the lack of rivalry. Thus, the fact of the merger between SBC and Ameritech would still not be sufficient to predict that, even in theory, the claimed greater ability of the merged firm to appropriate the return to innovation would increase the extent of innovation in the marketplace. Whether this occurs depends on a host of factors, only one of which is the public-good characteristic of R&D identified by Gilbert and Harris.

Importantly, a number of economic models specifically address the effect of market structure on the incentive to innovate. In these models, a single incumbent firm like SBC or Ameritech confronts a would-be entrant in its market. In some of these models, the incumbent has an incentive to invest *less* in R&D than the entrant does, particularly when the innovator will win the entire market. This occurs because the incumbent firm receives a continuing flow of profits prior to the discovery of the innovation, a flow that it would like to protect. The more R&D it undertakes, however, the sooner will the innovation be discovered, and the lower will be its post-innovation profits. As a result, the incumbent will have a smaller incentive to invest in innovation than an entrant, which has no pre-innovation profit flow to protect.⁴⁹

⁴⁹ Jennifer F. Reinganum, in "The Timing of Innovation: Research, Development, and Diffusion," in R. Schmalensee and R. Willig (editors), *Handbook of Industrial Organization* (Amsterdam: North-Holland, 1989), Volume 1, Chapter 14, pp. 849-908 (henceforth Reinganum), observes (p. 851) that "When innovation is uncertain, a firm which currently enjoys a large market share will invest at a lower rate than a potential entrant, for an innovation which promises the winner a large share of the market."

Viewed from the perspective of these models, SBC and Ameritech are incumbents with a virtual monopoly in the sale of local exchange services, which is characterized by the potential for the introduction of new offerings, new technologies, and new approaches to marketing, all of which could displace traditional approaches to providing telecommunications services. Indeed, Gilbert and Harris claim that, in the context of the new services that could replace the essential “last mile” facilities controlled by SBC and Ameritech, new providers with uncertain prospects might win a large share of the market. Thus, because SBC and Ameritech have a large flow of profits from the current method of providing telecommunications services, both may have lower incentives to innovate than do these entrants.

Professors Katz and Salop conclude that the merger will increase the ability and incentive of SBC and Ameritech to foreclose access by rivals to the essential facilities SBC and Ameritech control. Against the background of these models of R&D, policies that increase an incumbent’s ability to forestall entry are likely to retard innovation because they reduce the benefits that the incumbents would reap through the innovation.

“Arrow... argued that for a drastic innovation (one which leaves the inventor a monopolist), an incumbent monopolist would have less incentive to invent than would an inventor who currently has no share in the market” (Reinganum, p. 868-869).

“Since the incumbent invests less than the challenger, the challenger is more likely to win the asymmetric patent race. Thus, one would empirically observe that challengers contribute disproportionately more large innovations” (Reinganum, p. 873). The “race” analyzed by this model is similar to the one Professor Carlton describes in his report: “These circumstances create a “race” in which firms that are among the first to deploy facilities and services have the greatest likelihood of long-run success” (Carlton Report, Para. 13).

Alternatively, if Gilbert and Harris are simply suggesting that the merger increases innovation incentives because it creates a larger firm regardless of its market share, then their analysis is incomplete. In particular, there are plausible theoretical circumstances in which larger size can *reduce* the amount and rate of innovation. Although larger firms may have greater access to resources and may better coordinate R&D efforts, they also face difficult problems of monitoring and managing employees. Opportunistic behavior by managers and employees within large bureaucracies can result in relatively inefficient R&D organizations.⁵⁰ Thus, large, bureaucratic organizations may not be as effective in performing R&D as smaller and more nimble competitors.

The empirical literature is not dispositive in assessing the extent to which more concentrated markets or larger firm size result in greater innovation. Cohen and Levin conclude that empirical studies provide “little support for the view that industrial concentration is an independent, significant, and important determinant of innovative behavior and performance”; they go on to conclude that methodological flaws in current empirical research on both size and market power issues permit only “fragile” inferences.⁵¹ However, Scherer and Ross note that “[i]t is nevertheless

⁵⁰ Scherer and Ross, op. cit., p. 652.

⁵¹ Wesley M. Cohen and Richard D. Levin, “Empirical Studies of Innovation and Market Structure,” in R. Schmalensee and R. Willig (editors), *Handbook of Industrial Organization* (Amsterdam: North-Holland, 1989), Volume 2, Chapter 18, pp. 1059-1107; (p. 1078). As in the theoretical literature, there are numerous studies suggesting, for example, that greater market concentration can reduce innovation. Cohen and Levin note (p. 1075) that “A finding that captured the imagination of numerous theorists was that of Scherer, who found evidence of a non-linear, “inverted-U” relationship between R&D intensity and concentration. Scherer found, using data from the Census of Population, that R&D employment as a share of total employment increased with industry concentration up to a four-firm

well-established that new entrants without a commitment to accepted technologies have been responsible for a substantial share of the really revolutionary new industrial products and processes.”⁵²

With respect to firm size, the Cohen and Levin review of the empirical literature observes that “[t]he most notable feature of this considerable body of empirical research on the relationship between firm size and innovation is its inconclusiveness.”⁵³ In some cases, there is a positive relationship between firm size and innovation; in others, there is no relationship; and in yet others, the relationship varies non-monotonically with firm size. Scherer and Ross conclude that “[t]echnical progress thrives best in an environment that nurtures a diversity of sizes and, perhaps especially, that keeps barriers to entry by technologically innovative newcomers low.”⁵⁴

In sum, there is no decisive theoretical or empirical literature that supports the claim that the proposed merger would promote innovation. Moreover, while Gilbert

concentration ratio between 50 and 55 percent, and it declined with concentration thereafter. This “inverted-U” result, in the context of a simple regression of R&D intensity against market concentration and a quadratic term, has been replicated by other scholars using the FTC Line of Business data...” (cites omitted). Gilbert and Harris quote France’s telecommunications minister as saying: “The world telecom market will be organized around three or four or five big global operators” (Gilbert and Harris Report, Para. 26). If this speculation turns out to be correct, then the market for large national or global business customers is likely to have a four-firm concentration ratio well in excess of 55%, and, according to the “inverted-U” hypothesis, industry expenditure on R&D might well be lower than it would be in a less concentrated structure. If the SBC merger results in an increase in the four-firm concentration ratio, industry expenditure on R&D may fall still further.

⁵² Scherer and Ross, op. cit., p. 653.

⁵³ Cohen and Levin, op. cit., p. 1069.

⁵⁴ Scherer and Ross, op. cit., p. 654.

and Harris claim that the SBC/PacTel merger resulted in a faster rate of innovation, they provide no evidence to support this claim.⁵⁵ Indeed, there might be a substantial risk that innovation would be slowed if the merger were to increase the incentives of SBC/Ameritech to engage in strategies that raised the costs of its rivals, thereby sheltering it from rivals that otherwise would be a source of innovation or would provide SBC/Ameritech with a heightened incentive to innovate.

Other claimed efficiencies in performing R&D appear to be based on a misunderstanding of SBC's and Ameritech's current businesses. For example, Gilbert and Harris assert that cost savings can be obtained by rationalizing R&D: "Redundant R&D expenditures can be avoided and the remaining R&D delivers more 'bang for the buck' because it benefits the total operations of the merged company."⁵⁶ However, this is contradicted by Schmalensee and Taylor: "In its decision in the Bell Atlantic–NYNEX merger, the FCC expressed the concern that elimination of duplicate R&D would also eliminate a source of non-price competition that could give customers added service variety and quality. That concern is largely absent in the current case because while SBC has a research division, Technology Resources, Inc. ("TRI"), *Ameritech has no equivalent organization*, and the firms do not compete through research and development efforts."⁵⁷

⁵⁵ Gilbert and Harris Report, Para. 32.

⁵⁶ Gilbert and Harris Report, Para. 30.

⁵⁷ Schmalensee and Taylor Report, Para. 20, emphasis added.

5.2 The diffusion of best practices

Gilbert and Harris claim that the merger would facilitate the diffusion of best practices between SBC and Ameritech, therefore lowering cost and facilitating the deployment of new services.⁵⁸ Schmalensee and Taylor make a similar claim.⁵⁹ However, neither report explains why the merger itself would have this effect. Since SBC and Ameritech do not compete with one another and, according to the application, had no intention of doing so, there would appear to be no current impediments to transferring best practices between them. Both firms would have an incentive to transfer cost-reducing best practices, since they would be permitted to retain the benefits under price-cap regulation. The transfer of best practices could be accomplished contractually by SBC and Ameritech.

Moreover, SBC and Ameritech do not necessarily have the incentives to implement the same practices. Because the costs and benefits of introducing any particular practice may differ between firms, a particular practice may currently be implemented by one of the merging firms but not the other, not because one firm is unaware of the practice, but because the two firms face different economic environments or different regulatory oversight. In these circumstances, the merger may actually *reduce* the incentive of the merged firm to adopt best practices.

⁵⁸ Gilbert and Harris Report, Paras. 41-42.

⁵⁹ Schmalensee and Taylor Report, Para. 13.